Journal of Comparative Business and Capital Market Law 7 (1985) 307–315
North-Holland

AN ECONOMIC PERSPECTIVE OF SEC CORPORATE DISCLOSURE [1]

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Richard Zecher argues that modern corporate finance theory provides a theoretical framework from from which SEC corporate disclosure can be analyzed. After examining four theories – portfolio theory, capital asset pricing theory, efficient market theory, and agency – Zecher posits that a series of questions are left unanswered. He then discusses how the "market for managers," which consists of a well-developed information system, is effective for monitoring management and has been underestimated. His proposal is made in light of the estimated costs to corporations of the current financial disclosure system. He concludes that use of modern corporate finance theory, although useful, also leaves a series of questions to be answered in the future.

1. Introduction

> The Committee has concluded that, notwithstanding the arguments of economists and others that the efficient market hypothesis, the random walk theory, and the strength of market forces have rendered obsolete or unnecessary much or all of the mandatory disclosure system administered by the Securities and Exchange Commission, these arguments are not sufficiently compelling to justify dismantling the existing system at this time (Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission (1978)).

The fifty-year old SEC corporate disclosure system remains an enigma to most economists. Part of the reason for the enigma is that few economists have made any serious effort to analyze the corporate disclosure system. Until quite recently the economics profession lacked a theoretical framework of the corporation, the capital markets, and the role of economic information that was adequate to the task of studying a government program generating detailed facts about individual corporations. Such a framework now exists in the set of propositions known as modern corporate finance theory. One object of this article is to draw together various parts of this theory relevant to the analysis of the SEC corporate disclosure system, and to review some of the studies that have been done in this area.

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0167-9333/85/$3.30

Corporate finance theory can shed light on the market failure explanation for the SEC disclosure system. What market processes is the system supposed to improve? What aspects of the corporation, viewed as a nexus of contracts, work better because of disclosure? Two other reasons also help to explain why economists have shown little interest in the SEC disclosure system. First, the disclosures are totally specific to individual corporations and deal with a minor part, usually estimated at twenty-five percent, of the firm's total risk of asset price or return volatility. Moreover, firm specific risk is easily shed through portfolio diversification. Second, the SEC disclosure system is a government program, not subject to the price and quality disciplines of the private marketplace. Therefore, according to public choice theory, various interest groups are the most important factor in shaping the system. Government programs are probably less sensitive than private sector programs would be to the programs' costs, or their effectiveness in providing useful information to the markets, or to other functions they might usefully serve. Judging from the remarks by the Advisory Committee on Corporate Disclosure quoted above, economists form one interest group that has had little influence on the direction SEC corporate disclosure has taken. Whether or not this is desirable can be debated; what is clear is that economists, through the development of modern corporate finance theory, have a great deal to say about the corporation and the markets in which the SEC corporate disclosure system operates.

2. Modern corporate finance theory and SEC corporate disclosure [2]

Modern corporate finance theory and practice have changed radically in recent years. The more important of these changes have direct relevance to the SEC corporate disclosure system.

2.1. Portfolio theory [3]

Modern portfolio theory has moved portfolio management away from the art of picking groups of "winners" to the science of constructing diversified portfolios that meet the risk/return preferences of investors. Portfolio managers are now routinely expected to obtain the maximum return for a given level of risk, or, equivalently, accept minimum risk for a given level of return. Properly diversified portfolios, even those comprising a relatively limited number of firms and industries, can efficiently eliminate up to about half the risk (volatility of return) of owning a single firm. This development means that managers need to know the risk characteristics of assets, how their returns vary with returns on other assets, and the market in general. Such information is obtained by managers and individual investors not from SEC documents, but from price and return histories that are available from many commercial sources.

The theory and practice of modern portfolio management raises important questions about firm specific SEC corporate disclosure. Does it aid portfolio managers in meeting their obligation to maximize return for a given portfolio risk? If so, how?

One possible answer to these questions is that SEC corporate disclosure improves the pricing of individual securities. However, the same portfolio techniques that work for American securities also work for foreign securities, and for mixtures of American and foreign securities. A second major branch of modern corporate finance theory suggests that securities are priced to reflect the risk they contribute to the total risk in a diversified portfolio, so that riskiness of a single firm cannot be evaluated in isolation. A third branch suggests that information disclosed through the SEC system plays a minor role compared to firms' voluntary disclosures or the price and return histories available to the investment public.

2.2. *Capital asset pricing theory* [4]

Capital asset pricing theory is widely used in the private sector to evaluate asset prices, and it has been used to provide evidence on asset pricing relevant to public policy issues. More efficient or accurate disclosure seems to have been an important role foreseen for SEC corporate disclosure in its early days, as exemplified by the sophisticated views of future Justice William O. Douglas during the 1930s:

> Even though an investor has neither the time, money, or intelligence to assimilate the mass of information in the registration statement, there will be those who can and who do so whenever there is a broad market. The judgment of those experts will be reflected in the market price [5].

The clear implication of this view is that pricing efficiency improves with SEC mandated disclosure.

In the 1960s and 1970s, as the capital asset pricing model was developed and refined, economists focused upon improving equity pricing through expanded SEC disclosure requirements. The results have not been generally favorable to the usefulness of SEC corporate disclosure in the asset pricing markets. As Susan Phillips and I concluded in our earlier review of the empirical work [6]:

> The evidence reviewed here provides no support for the notion [that the SEC disclosure system improves pricing efficiency in the asset markets], as it relates to markets for secondary issues, and at best weak or inconclusive support, as it relates to markets for new issues. It would seem that, if we are to discover the benefits of the SEC disclosure system, we must look elsewhere [7].

As is typical in quantitative economic studies, the findings are open to differing interpretations and to an array of criticisms including statistical

technique and quality of basic data. Yet it is hard to see how those who view SEC corporate disclosure as the centerpiece of an information system that supports the pricing of American corporations can glean much comfort from these empirical studies.

2.3. Efficient market theory

A third major branch of modern corporate finance, efficient market theory, provides another way of viewing SEC corporate disclosure. The basic tenet of this theory is that a market is efficient in the pricing of assets if it is impossible to make systematic, or continuing, economic profits by trading on available information. Early studies [8] showed the inability to forecast stock prices, and that stock prices followed a "random walk," behaving as if they were independent random drawings.

An extension of this theory [9] revolutionized macroeconomic theory by dividing all forward-looking variables into "expected" and "unexpected" components. In a rational expectations framework, economic agents will act now on their expectation of the future, and only the unexpected surprises will have further effect on behavior at the time they occur. The questions facing macro-economic theorists are similar to those which should be facing SEC corporate disclosure administrators. How do market participants form their judgments on expected returns and risks? Is the information provided by SEC mandated corporate disclosure an important part of this process? If not, why are we doing it?

2.4. Agency theory

A fourth, and the newest branch of corporate finance theory is agency theory [11]. An example of an agency relationship most relevant to corporate disclosure activities is the role of corporate managers as agents to stockholders. The most interesting questions concern how to design compensation schemes to induce agents to behave in the best interests of the principals, and how to devise the most effective system for monitoring the agents' behavior.

Assuming that the compensation scheme for management is set competitively to meet marketplace standards and is designed to encourage managers to act in the equity owners' best interest, we can turn our attention to the monitoring function. Effective monitoring requires equity owners to take a personal interest in managing the firm. Few equity owners, however, devote much of their time to monitoring since most investors spread their wealth over many firms. In a sense, these equity owners exchange the risk associated with any single firm for the average "manager" risk in the market. While this reduces their exposure to any one firm and any single team of managers, and consequently reduces their incentive to monitor or run any particular firm, it does not remove their incentive to monitor their agents effectively.

Another obvious monitoring device is the regular publication of audited financial results for the firm and other verifiable information that chronicles the management's performance. Reliable corporate financial disclosure plays a useful private sector role in supporting the corporate form of business enterprise. Evidence supporting this proposition comes from the fact that elaborate corporate disclosure existed in the United States prior to the SEC and in foreign markets. Benston reports:

> The degree of disclosure of financial data also reflects the demand for data by investors and the economies of supply by corporations. In 1926, all of the New York Stock Exchange listed corporations published balance sheets and net income, fifty-five percent disclosed sales, forty-five percent disclosed cost of goods sold, seventy-one percent disclosed depreciation and eighty-two percent were audited by CPAs. By the year prior to the requirement of disclosure by the Securities and Exchange Act of 1934, the percentage of corporations disclosing sales had risen to sixty-two, fifty-four percent had disclosed cost of goods sold, and ninety-three percent had disclosed depreciation. Ninety-four percent of the listed corporations were audited by CPAs [12].

If private markets, in the absence of government regulation, would devise methods to assure the disclosure of all relevant financial information audited and uniformly presented, then arguments in favor of mandating such disclosure by law are weakened. Mandating disclosure may seem appealing on the reasoning that if it is desirable to disclose such information to help monitor the behavior of management for large corporations, like those traded on the NYSE, then it is also desirable to do so for smaller ones. This argument, however, ignores the costs involved. There are major economies of scale in disclosure. The cost of disclosure, as a proportion of sales or assets, rises dramatically as firm size declines. Thus, prior to the SEC, audited financial disclosure was generally not an important part of the market mechanisms that developed to aid in monitoring the behavior of management and other agents in smaller corporations.

2.4.1. The market for managers: a system for monitoring management

Agency theory suggests that another management monitoring system is the market for managers, which can serve as an additional, if somewhat drastic, monitoring device. Henry Manne has called the corporate takeover the market for corporate control [13]. The market for corporate control has been quite active recently, particularly in those industries undergoing massive regulatory and technological change. This device for disciplining management and protecting the interests of shareholders has accordingly received much attention. The market for managers, however, both inside and outside the corporate, has been largely ignored as an important part of the system that monitors management behavior. This is an important oversight since manager markets, both inside and outside the corporation, are large markets with great liquidity and large numbers of transactions. The manager markets consist of a well-de-

veloped information system with no significant monopoly elements. These markets are highly, if not perfectly, competitive.

Shareholder interests are served when management is highly motivated to strive for higher productivity and better performance, thereby raising the value of the firm. How do outside and inside markets for managers monitor management behavior and contribute to these goals? The primary function of the outside market for managers may be to monitor the adequacy of the corporation's reward system. If a corporation's reward system for managers is not sufficiently responsive to productivity and performance, the firm will not be able to attract new management talent, or to keep the best of its existing management talent. Since corporations are seeking new management talent almost continuously, and since the market for managers is so well organized, the news that a corporation inadequately rewards performance, and hence is not acting in its shareholders' best interests, quickly becomes common knowledge.

The monitoring role played by the market for managers within the firm has been underestimated. This internal market may be just as important as the outside management market from the point of view of shareholders.

> There is also much internal monitoring of managers by managers themselves. Part of the talent of a manager is his ability to elicit and measure the productivity of lower managers, so there is a natural process of monitoring from higher to lower levels of management. Less well appreciated, however, is the monitoring that takes place from bottom to top. Lower managers perceive that they can gain by stepping over shirking or less competent managers above them. Moreover, in the team or nexus of contracts view of the firm, each manager is concerned with the performance of managers above and below him since his marginal product is likely to be a positive function of theirs. Finally, although higher managers are affected more than lower managers, all managers realize that the managerial labor market uses the performance of the firm to determine each manager's outside opportunity wage. In short, each manager has a stake in the performance of the managers above and below him, and, as a consequence, undertakes some amount of monitoring in both directions [14].

Together, the inside and outside markets for managers provide powerful forces for monitoring and enhancing management performance. If these markets for management were not so competitive and so effective in inducing high levels of management performance, it is difficult to imagine how our corporate structure, so dependent on the willing separation of "ownership" and "control," could be sustained.

Modern corporate finance theory offers many important insights into the corporate form of business organization. It not only recognizes the conflicts that arise when shareholders and their agents (management) are separated, but it also recognizes that the marketplace has developed some very effective mechanisms to deal with these conflicts. Shareholders, first of all, can replace the risk they are subject to from a particular management team by the risk associated with the "average" management team by diversifying their wealth across many firms. This reduces risk, but it would not be nearly so attractive a

way of managing the risk of separation of ownership and control if there were little confidence in the ability of the market to induce high levels of "average" management performance. The existence of highly competitive inside and outside markets for managers assures that performance usually will be carefully monitored. Managements that are exceptions to these tendencies will be subject to discipline from the capital markets, where their shares are priced and credit ratings established, and ultimately by the threat of corporate takeover by more competent management teams or by investors. At this point the losing management team must retire or re-enter the market for managers, where their previous performance is a major factor in their market value.

3. Estimated costs of SEC disclosure

An important policy question concerning SEC corporate disclosure is how much it costs. Unfortunately, no precise answer is available since estimates of the various components of these costs are not regularly disclosed. One sample of some of these costs, however, was produced by the Advisory Committee on Corporate Disclosure (1977). This sample of costs, though small and not scientifically designed to allow easy extrapolation to all reporting firms, has been used to generate macro-estimates of some SEC corporate disclosure costs for the sample year, 1975 [15]. This section discusses some of the findings of that research.

The cost information requested from issuers in the Advisory Committee's sample focused solely on fully variable costs. The surveyed firms were specifically instructed not to allocate to the preparation costs of documents any general overhead expenses. The firms were also not to include any costs incurred initially to set up new or additional accounting or auditing systems to meet mandated disclosure standards. The only costs allowed were those that could be immediately and fully eliminated if the mandatory corporate disclosure were closed down.

In table 1, some of these cost estimates for both voluntary and corporate disclosure and SEC mandated disclosure (10K, 10Q and 8K) are shown for the year 1975. Firms are broken down into large (assets averaging $2.6 billion), medium (assets averaging $257 million), and small (assets averaging $26 million), so that the effects of size on reporting costs can be examined. Reporting costs as a percent of assets rise dramatically for smaller firms for both voluntary and SEC disclosures, but this rise is much more pronounced for mandated disclosure.

The table reports an estimated $213,500,000 for the fully variable costs of 10K, 10Q and 8K disclosures in 1975. To this should be added the separate estimate (not shown) of $191,900,000 for disclosure related to new issues in 1975, for a total estimate of about $400,000,000 for SEC disclosure costs in

Table 1
Costs of voluntary and mandatory periodic disclosure by corporations as percent of assets, 1975

		Voluntary disclosure				Mandatory periodic disclosure		
Firm size (assets)	Number of firms	Certified end of year stmt ($1M)	Annual report ($1M)	Total cost ($1M)	Cost as a % of assets	Costs of 10K, 10Q and 8K ($1M)	total cost ($1M)	Costs as a % of assets
Large ($2.6 billion)	734	723.4	149.9	644,700	0.034	57.1	41,900	0.0022
Medium ($268 million)	1,859	243.2	194.7	814,100	0.163	19.6	36.400	0.0073
Small ($26 million)	7,191	72.9	47.3	864,400	0.462	18.8	135,200	0.0723
Total	9.784			2,323,200			213,500	

Sources: Financial data from "Report of the Advisory Committee on Corporate Disclosure," House Committee on Interstate and Foreign Commerce, Committee Print 95-29, November 3, 1977. Registrations filed were developed from a 1 in 10 sample of the registrations listed in the *SEC News Digest*, issues 75-1, dated January 2, 1975, through 75–250, dated December 30, 1975.

1975. These estimates are biased downward because they do not include various fixed costs associated with SEC disclosure. While there is no estimate of the magnitude of these costs, the cost estimates are highly sensitive to the amount of "voluntary" disclosure expenses that should actually be in the "mandatory SEC" disclosure categories. For example, if ten percent of the "voluntary" expenses are actually overhead for 10K, 10Q and 8K disclosures, or for new issue disclosure, then that would have added about $200 million per year to the total costs of the SEC disclosure system in 1975.

5. Conclusion

Modern corporate finance theory and practice has presented a series of unanswered questions for the SEC corporate disclosure system. What market processes is the system supposed to improve? What aspects of the corporation, viewed as a nexus of contracts, work better because of corporate disclosure? How could we tell if specific corporate disclosures were meeting their goals? How can the system, which seems not to change in response to changing markets, be made more sensitive to market discipline? How can the system be made more responsive to the disclosure costs that it imposes, through the corporation, ultimately on shareholders, customers, management, suppliers, and others? These important questions need to be addressed in the future.

Notes

[1] Much of this paper is based upon S. Phillips & J. Zecher, The SEC and the Public Interest (1981).

[2] For a brief overview of the basic theories of corporate finance, see M. Jensen & C. Smith, The Modern Theory of Corporate Finance at 2–8 (1984) [hereinafter cited as Corporate Finance].

[3] *See* H. Markowitz, Portfolio Selection: Efficient Diversification of Investments (1959); Markowitz, *Portfolio Selection*, 7 J. Fin. 77 (1952).

[4] *See* Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 Rev. Econ. & Stat. 13 (1965); Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19 J. Fin. 425 (1964); Corporate Finance, *supra* note 2, at 6.

[5] Douglas, *Protecting the Investor*, 23 Yale Rev. 521, 523–24 (Mar. 1934).

[6] *See, e.g.*, Benston, *Required Disclosure and the Stock Markets: An Evaluation of the Securities Exchange Act of 1934*, 63 Am. Econ. Rev. 133 (1973); Friend & Herman, *Professor Stigler on Securities Regulation: A Further Comment*, 38 J. Bus. 106 (1965); Stigler, *Comment*, 37 J. Bus. 82 (1964); Stigler, *Public Regulation of the Securities Markets*, 37 J. Bus. 117 (1964); Stigler, *Comment*, 37 J. Bus. 414 (1964).

[7] *See, supra* note 1, at ch. 3.

[8] *See, e.g.*, Cowles, *Can Stock Market Forecasters Forecast?*, 1 Econometrica 309 (1933). For a discussion of recent literature, see Corporate Finance, *supra* note 2, at 4.

[9] Samuelson, *Proof That Properly Anticipated Prices Fluctuate Randomly*, 6 Indus. Mgmt. Rev. 41 (1965).

[10] Corporate Finance, *supra* note 2, at 7.

[11] *Id.* "Narrowly defined, an agency relationship is a contract in which one or more persons [the principal(s)] engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority."

[12] Benston, *Accounting Standards in the United States and the United Kingdom: Their Nature, Causes and Consequences*, 28 Vand. L. Rev. 235, 254 (1975).

[13] Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Economy 110 (1965).

[14] Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Economy 288 (1980).

[15] *Supra* note 1, at ch. 3.

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